Monthly Letter

May 2022

prodigy INVESTMENT MANAGEMENT

Invest well. Celebrate life.

We were -1% for the month of April vs -2.1% for the NIFTY50. For the rolling 12 months, we are +26.9% vs +16.9% for the NIFTY50. ₹1 invested in Prodigy Growth Strategy on 1 March 2012 is today worth ₹9.4 (post fees) against ₹3.2 if invested in NIFTY50 (TWRR basis). The month played out as we anticipated. Essentially range-bound with a negative bias. We see the positive domestic economic impulse being offset by the significant global headwinds. There are many signs of this, such as the flat to lower consumption of consumer goods as a result of high inflation. We plan to maintain a cautious approach and are holding approximately 10% of portfolios in cash. In general, we see this financial year as a challenging one. In a sense, the market has over the past couple of years discounted the extant domestic economic recovery, and now that it is occurring, it is likely to have no further impact in the near to medium term.

While reasonable inflation, per se, is good for markets, especially if it is demand-side-led, the current bout of inflation, which is essentially supply-side-led, is much more damaging. Demand-led inflation allows for cost pressures to be passed on much more easily and businesses can maintain margins. However, when inflation is supply-side led, as it is at the moment (due to the events in Ukraine and China; resulting in an almost a never-before-seen surge in commodity prices across the board), then passing on raw material cost hikes can result in demand impairment, which is the case currently. Thus, the fears of stagflation are real.

In a sudden and unscheduled move yesterday, the RBI has raised repo rates by 0.4% and raised the CRR for banks by 0.5%; which is reflective and an acknowledgement of the inflationary situation we are in, at the moment. However, it is a positive move, in the sense that unlike other Central Banks in the developed world, RBI has recognised that it is falling behind the curve in tackling the surge in inflation and taking quick measures to rectify its stance. This is better than behaving like an ostrich with its head in the sand, as other Central Banks have been for some time now. At least, in India, real interest rates are close to zero, whereas, in other developed markets, real interest rates are hugely negative, which means that the tightening cycle there has to become more aggressive with negative implications.

This clearly signals that we are now in a rate tightening cycle and more hikes are likely to follow in the months ahead. This is a negative for investors, as higher interest rates mean a lower valuation level for equities (based on discounted cash flow). Given that the LIC IPO is on at the moment, it is heartening to get a reminder that India's central bank seems to be quite politically independent.

The slowdown in the US economy appears to already be here, with data showing a surprise shrinkage in the economy in the last quarter, as against the expectation of moderate growth. While this in the past may have been a reason for the US Fed to defer any rate hikes; the Fed is already so far behind the tightening curve, that this is highly unlikely, and the Fed is likely to hike rates through this year by at least 2.5%. Other developed economies are also on the same path, and this is showing up in the continuous selling by foreign investors over the last many months. The world is also experiencing the painful transition from QE (quantitative easing) to QT (quantitative tightening). The superior performance of the Indian market (and therefore the richer valuation) relative to other emerging markets over the last years, has made this an easy decision for them. Thus far this selling has been fully absorbed by domestic retail and institutional investors, but it nevertheless remains a strong headwind at the moment.

The GST collections last month, at a record ₹1.68 lakh crores (vs levels of approximately ₹1.3 lakh crores for the last few months), point to a buoyancy in the economy as well as better compliance measures showing results. India's revenue collection, in both direct and indirect taxes, has been a positive surprise over all of the last fiscal year and this strong performance appears to be continuing. This is a significant positive for markets as in these challenging times, revenue buoyancy means less pressure on the Government to borrow and thus less pressure on interest rates.

Supply-side pressures continue to manifest in the current earnings season. High commodity costs, supply chain issues, and chip shortages; are all resulting in production and cost pressures for corporate India. These had started to ease up towards the end of the calendar year 2021, but due to the Ukraine war as well as, the lockdowns in China, these have further intensified and the guidance appears to be that these are likely to persist for another two quarters at least.

While there appear to be many challenges in the near to medium term, we steadfastly believe that beyond this, the Indian market is one of the best places to be over the next few years. We have discussed many a time, in past Monthly Letters, why in the long term our market holds tremendous potential. This is slowly taking shape, as is being seen in the GST collection data. The benefit of reforms can take time to show up, but the die is cast. Once the headwinds ease, we believe our market will respond positively. Till then one should see this as a time to pick and choose where to invest. In fact, these times allow for considered decision making, rather than having to make super quick decisions when markets are running.

Best wishes,

RC

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